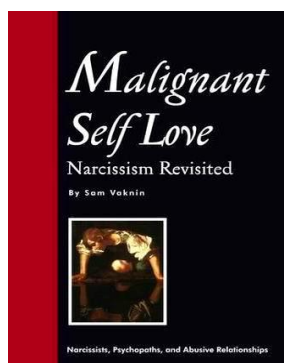


Foreign Direct Investments (FDI) - Pros and Cons

Based on a lecture given at the Euro College Student Union Business Forum, Kumanovo, Macedonia, May 3, 2007

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The role of foreign direct investment (FDI) in promoting growth and sustainable development has never been substantiated. There isn't even an agreed definition of the beast. In most developing countries, other capital flows - such as remittances - are larger and more predictable than FDI and ODA (Official Development Assistance).

Several studies indicate that domestic investment projects have more beneficial trickle-down effects on local economies. Be that as it may, close to two-thirds of FDI is among rich countries and in the form of mergers and acquisitions (M&A). All said and done, FDI constitutes a mere 2% of global GDP.

FDI does not automatically translate to net foreign exchange inflows. To start with, many multinational and transnational "investors" borrow money locally at

favorable interest rates and thus finance their projects. This constitutes unfair competition with local firms and crowds the domestic private sector out of the credit markets, displacing its investments in the process.

Many transnational corporations are net consumers of savings, draining the local pool and leaving other entrepreneurs high and dry. Foreign banks tend to collude in this reallocation of financial wherewithal by exclusively catering to the needs of the less risky segments of the business scene (read: foreign investors).

Additionally, the more profitable the project, the smaller the net inflow of foreign funds. In some developing countries, profits repatriated by multinationals exceed total FDI. This untoward outcome is exacerbated by principal and interest repayments where investments are financed with debt and by the outflow of royalties, dividends, and fees. This is not to mention the sucking sound produced by quasi-legal and outright illegal practices such as transfer pricing and other mutations of creative accounting.

Moreover, most developing countries are no longer in need of foreign exchange. "Third and fourth world" countries control three quarters of the global pool of foreign exchange reserves. The "poor" (the South) now lend to the rich (the North) and are in the enviable position of net creditors. The West drains the bulk of the savings of the South and East, mostly in order to finance the insatiable consumption of its denizens and to prop up a variety of indigenous asset bubbles.

Still, as any first year student of orthodox economics would tell you, FDI is not about foreign exchange. FDI encourages the transfer of management skills, intellectual property, and technology. It creates jobs and improves the quality of goods and services produced in the economy. Above all, it gives a boost to the export sector.

All more or less true. Yet, the proponents of FDI get their causes and effects in a tangle. FDI does not foster growth and stability. It follows both. Foreign investors are attracted to success stories, they are drawn to countries already growing, politically stable, and with a sizable purchasing power.

Foreign investors of all stripes jump ship with the first sign of contagion, unrest, and declining fortunes. In this respect, FDI and portfolio investment are equally unreliable. Studies have demonstrated how multinationals hurry to repatriate earnings and repay inter-firm loans with the early harbingers of trouble. FDI is, therefore, partly pro-cyclical.

What about employment? Is FDI the panacea it is made out to be?

Far from it. Foreign-owned projects are capital-intensive and labor-efficient. They invest in machinery and intellectual property, not in wages. Skilled workers get

paid well above the local norm, all others languish. Most multinationals employ subcontractors and these, to do their job, frequently haul entire workforces across continents. The natives rarely benefit and when they do find employment it is short-term and badly paid. M&A, which, as you may recall, constitute 60-70% of all FDI are notorious for inexorably generating job losses.

FDI buttresses the government's budgetary bottom line but developing countries invariably being governed by kleptocracies, most of the money tends to vanish in deep pockets, greased palms, and Swiss or Cypriot bank accounts. Such "contributions" to the hitherto impoverished economy tend to inflate asset bubbles (mainly in real estate) and prolong unsustainable and pernicious consumption booms followed by painful busts.

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